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C O R R E C T E D C O P Y (MRN 02475 VICE 02419
DEPT FOR EB/TPP/ABT THOMAS LERSTEN
COMMERCE FOR ITA/OTEXA MARIA D'ANDREA
USTR FOR ABIOLA HEYLIGER

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SUBJECT: TEXTILES AND APPAREL SECTOR UPDATE FOR EL SALVADOR

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¶1. (SBU) SUMMARY: This is in response to reftel. El Salvador continues to have a strong apparel sector that generates most of the country's export revenue, but faces challenges in the future. Rising labor and energy costs are reducing margins in the sector, and the possible phase-out of export incentives is affecting the investment environment. The staggered entry into force of CAFTA-DR in El Salvador vis a vis other Central American countries meant a temporary drop in exports to the U.S., but export figures have recovered and the free trade agreement has increased investment interest. END SUMMARY.

Sector Employment and Production

¶2. (SBU) El Salvador's apparel industry was hurt by competition from Asia beginning in 2004-2005, and has not recovered those losses. According to Anamaria Rivas, Manager of Export Salva Free Trade Zone, CAFTA-DR is good, but came too late to save those jobs. As of September 2006 the textile and apparel industry accounted for approximately 61,000 jobs according to CAMTEX, the apparel and textile association. However, the Salvadoran Institute for Social Security (ISSS) showed 59,000 jobs in the sector. The latest figures for the overall manufacturing sector were from 2004, and showed 423,000 people employed in the sector.

¶3. (SBU) El Salvador's total industrial production was $3.693 billion for 2005 and $1.93 billion in the first half of 2006. Textile and apparel production accounted for $1.92 billion in 2005 and $979 million for the first half of 2006. In 2005, El Salvador's apparel sector exported $1.65 billion in merchandise to the United States, and $777 million in the first six months of 2006. Last year apparel and textile production accounted for 53.7 percent of exports, and 46 percent for the first six months of 2006. The total import share was 20.7 percent in 2005, and 16.9 percent for the first six months of 2006. These figures dropped due to the staggered implementation of CAFTA-DR, which entered into force for El Salvador on March 1, 2006, ahead of other countries. CAFTA-DR rules of origin requirements temporarily lowered imports and exports until other countries entered into force. Import and export figures have since rebounded to the averages of prior years.

Salvadoran Market Faces Rising Costs and WTO regulations

¶4. (SBU) Apparel manufacturers in El Salvador face competition not only within the Central American market, but from China in particular and Asia in general. El Salvador has a good workforce with higher productivity than other countries in the region, but also has higher costs. Anamaria Rivas said companies that have production in El Salvador and other Central American countries can see the difference in productivity and place a value on Salvadoran labor. Companies with no point of comparison only look at labor costs, and she has seen some of these companies move elsewhere to

save on labor costs. El Salvador recently raised its minimum wage 10 , but only gave a 4 raise to textile and apparel sector workers, who now have a minimum wage of $157.26 per month. Roberto Bonilla, president of CAMTEX said that only workers in the first month or so of a job earn the minimum wage, and then start to receive higher wages through incentives. However, as the minimum wage figures are used to calculate other rates of pay, the increase does affect overall costs in the sector.

¶5. (SBU) In addition to labor costs, El Salvador has seen an increase in electrical rates, particularly damaging to high users of electricity such as the apparel sector. Electrical rates increased between 25 percent and 30 percent for industrial users, depending on the level of use. The increase in rates is due to the dependence on electricity generated using petroleum products, and the high costs of petroleum. There are no short term solutions on the table for this problem. While it is unlikely that there will be a significant increase in prices in December when rates are recalculated, this is a problem confronting the industry unless alternatives to petroleum generation are found. These increased costs, coupled with buyers requests for lower pricing, leave very little profit margin in the business in El Salvador.

¶6. (SBU) Looming on the horizon is the required phase out under WTO regulations of incentives for free trade zones - where most apparel and textile companies operate - beginning in 2008. Companies now receive duty free importation of capital goods, unrestricted remittance of net profits, exemptions up to 15 years from income taxes and up to 10 years from the municipal taxes. The GOES will attempt to negotiate a 10 year extension in the expiration date for the current benefits, bringing it in line with phase outs for other countries in the region. The GOES is also working on a Service Law that would offer alternative incentives for companies inside free zones that the GOES believes could be accepted by the WTO. Textile and apparel industry representatives have stated that without the

fiscal benefits offered by the free zones, they would not be able to compete with other countries such as Honduras and Nicaragua, where incentives are not scheduled to phase out for years. They said the impact would be as bad as if there was no CAFTA-DR. While we do not know of any companies have decided against investing due to this issue. Still, there are concerns that it will begin to impede investment.

CAFTA-DR Implementation

¶7. (SBU) El Salvador was the first country in Central America to enter into force with CAFTA-DR, and while it showed the level of interest and hard work of the GOES to make the agreement work, staggered implementation had effects within the apparel industry. El Salvador could not use inputs such as fabric and thread produced in non CAFTA-DR countries to manufacture apparel and import it duty free into the United States. This, along with customs delays at ports in the United States during the initial implementation phase dropped apparel export figures for El Salvador, in some product lines by 25 percent. According to the Salvadoran Central Bank, export figures in the sector from January - August 2006 dropped 10.7 percent compared with figures for the similar period in 2005. The export figures have since rebounded, with June and July 2006 U.S. import figures for apparel from El Salvador, as reported by the Department of Commerce, reaching average monthly levels from 2005.

¶8. (U) The GOES has done an excellent job promoting the country as a manufacturing center, and has done much to make El Salvador attractive to investors. El Salvador has an excellent road infrastructure, and a number of projects are underway that will further improve logistics. The port of Acajutla has expanded its container storage facilities, and traffic increased 30 percent in the first half of this year. Construction of a new container port at La Union continues, and it is expected to open in 2008. The Millennium Challenge Corporation is in the last stages of negotiating a compact with El Salvador, the basis of which is a third East - West highway that will improve traffic flow and commerce in the country. Continued efforts at customs integration have seen improvements in transit times for goods transiting the

region, which is important for El Salvador as it must export via Honduras or Guatemala to access U.S. east or gulf coast markets. PROESA, the GOES investment agency, is actively seeking investment in El Salvador with an eye for taking advantage of CAFTA-DR. An example of such investment is LaCoste, which opened a plant to export under CAFTA-DR to access the U.S. market.

Comment

¶9. (SBU) El Salvador is in a good position to compete in the apparel market with CAFTA-DR, but competition within the region and from Asia is strong. El Salvador faces significant challenges in the sector, namely rising labor and energy costs, as well as an uncertain future of export incentives. It must continue to work to diversify its industry and take advantage of its relative proximity to the United States and a proficient labor force. According to Roberto Bonilla, companies are interested in managing risk through diversification, and investing in El Salvador is one way to counterbalance Asian investment. El Salvador's stable political environment and active attraction of investment are helping the sector, but it will have to work hard to maintain and increase market share.

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